Operator. Ladies and gentlemen, thank you for standing by. Welcome to the CTG Third Quarter 2017 Conference Call. Now at this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. [Operator Instructions]. As a reminder, today's call is being recorded. And your hosting speaker is Director of Investor Relations at CTG, Jim Culligan. Please go ahead, sir.

Jim Culligan. Thank you, Kevin. Good morning, everyone. With me on today's call are Bud Crumlish, CTG's President and Chief Executive Officer; and John Laubacker, Senior Vice President and Chief Financial Officer. Before we begin, I want to mention that statements during the course of this conference call that state the Company's or management's intentions, hopes, beliefs, expectations, and predictions for the future are forward-looking statements. It's important to note that the Company's actual results could differ materially from those projected. These forward-looking statements are based on information as of today, Tuesday, October 24, 2017. The Company assumes no obligation to update these statements based on information from and after the date of this conference call. Additional information concerning factors that could cause actual results to differ from those made in forward-looking statements is contained in our earnings release, as well as the Company's filings with the SEC.

Also, the Company's press release and management's statements during this conference call will include discussions of certain adjusted non-GAAP measures and financial information. These financial measures and a reconciliation of GAAP to non-GAAP results are provided in both today's press release and the related Form 8-K. It's now my pleasure to turn the call over to Bud for his opening remarks.

Bud Crumlish. Thanks, Jim, and good morning to everyone on the call. I'll begin with a brief overview of our third quarter financial results. As previously announced in today's press release, revenue for the quarter was $74 million, which was below our guidance range of $75 million to $77 million due to the soft demand at our three largest staffing clients.

We continue to see a reduction in headcount at these accounts, combined with a decrease in the issuance of new requisitions. We don't believe these dynamics are unique to CTG, but instead are client specific challenges at each of these accounts. This softness in demand continued to more than offset our growth in Europe, as well as the incremental contributions from the early ramp of newly secured business in the U.S.

Also, we announced during the quarter we incurred a significant and unexpected increase in medical costs associated with our self-insured plan negatively impacting earnings by approximately $0.05 per share. These expenses were well above our historical averages and were primarily due to unusually high critical illness claims. If we didn't incur these increased costs, earnings from operations for the quarter would have met the midpoint of our expectations of $0.05.

Despite these unanticipated developments, during the quarter we continued to make progress on our new business initiatives in support of our strategic objectives. In fact, when looking at revenue, excluding our three largest clients it grew 6.7% year-over-year. Additionally, our revenue from Europe grew 13% year-over-year, excluding the favorable impact from currency, representing the seventh consecutive quarter of growth.

And supported by new business efforts, we continue to work aggressively to strengthen CTG's sales teams, both in size and effectiveness, across the organization. We are actively focused on expanding our sales capability within staffing and healthcare, particularly in geographies and end markets where CTG already has a well-established presence. We are still in the early stages of increasing the size of our sales teams, and we have internal goals for making further additions to both our staffing and healthcare sales teams by year-end.

I'll now provide you with an update on the newly created executive sales leadership position that I introduced on our last quarter call. The responsibilities of this role will include overseeing and leading our sales efforts in North America. At the time of our last conference call we had a signed commitment letter and planned start date from a promising candidate to fill the position. Unfortunately, this individual subsequently decided to stay at their current employer. We reinitiated the search process, and I look forward to filling this role in the coming months and publicly announce the appointment once an individual has been hired.

Now, I'll address more specific developments related to our staffing and solution businesses, followed by commentary in our focus areas of Europe, healthcare and diversified industrials.

In staffing, which represented roughly 70% of total revenue, business was down approximately 1.6% sequentially due to the ongoing weakness at our three largest staffing clients that I previously mentioned. We remain confident in the strength of our respective relationships with these accounts, and we continue to believe that these are specific client headwinds, as the broader market environment appears relatively healthy and favorable.

However, I am pleased to announce that we recently signed a two-year extension through December 31, 2019 on our existing technical service contract with our largest staffing client. As a point of reference, this contract has historically represented annual revenue in excess of $70 million.

Beyond these large staffing clients we are making tangible progress on our new business expansion initiatives, as we begin to convert pipeline opportunities into secured business. Recently, we started a new business with a large public university system that we believe will become a meaningful revenue contributor in 2018. This business win also has broader significance in that it represents our expansion into a new end market that can have substantial potential over the long term.

As further evidence of our progress, last quarter we highlighted that we had secured incremental work in an existing global IT management and services client that represents an opportunity to significantly expand our North American footprint. I am pleased to report that we are actively transitioning an initial group of individuals and anticipate transitioning a second larger group in 2018. This is another example of a significant incremental win that we believe has the potential to grow into a future, top-five staffing client.

Turning to the solutions business, which accounted for 30% of total revenue, we were down modestly both sequentially and year-over-year. Legacy revenue continued to show signs of stabilization, and we are seeking contributions from new business, even though it's in the early stages of ramping. CTG's core solution offerings include application, development and management, IT service desk, implementation and optimization, as well as testing execution. Our longer term strategic objective within the solutions business is to increase its revenue contribution as a percentage of total revenue through the expansion of higher margin offerings.

Since formally announcing CTG's Application Advantage solution in May of this year we have seen considerable interest, as well as progress, on an increasing number of client engagements within financial services, healthcare and diversified industrials. As we work with new prospective clients to maximize efficiency and lower cost, we are better able to understand our clients evolving service needs. Our global solutions team can then respond with development and launch of new solutions.

Underlying this early traction for CTG's Application Advantage solution is the steady increase in enterprise-wide collaboration that we systematically incurred through our One CTG program. In addition to establishing a framework for cross-selling both our staffing and solutions, I believe our One CTG program is truly helping to reshape and cultivate a more sales-oriented culture across the enterprise. Importantly, this further increases the total value we provide to our clients, while also providing CTG the benefits of greater reach and utilization.

Now I'll provide a few updates and highlights on each of our three focus areas, which include Europe, Healthcare and Diversified Industrials.

Starting with Europe, we have a stable and growing client base across the countries of Belgium, Luxemburg and the U.K. Collectively, our business in Europe grew to approximately $20 million, or 27% of revenue, representing an increase of 13% year-over-year excluding the benefit of favorable currency translation. This was the seventh consecutive quarter of year-over-year growth in Europe which was achieved through a combination of growth from both staffing and solutions as well as incremental business at new and existing clients. As a result, we experienced meaningful growth in billable headcount during the quarter, in part due to strong demand in our financial services and technology aggregator markets.

Our seasoned sales team in Europe continues to execute well on our strategy of capturing incremental market share by leveraging CTG's leadership position in key market verticals and geographies while simultaneously targeting new opportunities in adjacent markets. During the quarter we converted a number of opportunities into notable new account wins, an example of which is a sizeable three year Application Advantage contract in Luxembourg. Additionally, the health solutions team secured our ninth EMR implementation in Belgium. As mentioned before, these implementations in Europe are typically smaller engagements than those we've historically secured in the U.S. However, many of these implementations include the opportunity to provide between three and five years of support work upon completion, which is favorable compared to what we have experienced in the U.S.

Let me emphasize that these new wins did not contribute to the growth in Europe during the third quarter, but will be drivers of future growth. Similar to most new contracts this incremental business will ramp over a series of months, and in many cases the full value of the contract is realized over multiple years. As reflected by our results, the pipeline of new business in Europe remains healthy and we feel confident about our prospects for continued growth.

Now turning to Healthcare. We continue to take steps to drive a more meaningful turnaround in this area of our business and return to growth. We already have a strong delivery team, and our current actions are focused on enhancing the effectiveness of our sales organization.

Consistent with our strategic objectives towards this renewed growth, we were pleased to announce the appointment of a prior CTG veteran, Rob Barras, as Vice President of Sales for our North America Healthcare business and a member of the executive team. Rob's 25 years of healthcare IT experience will be invaluable as he oversees the positioning and execution of CTG's healthcare sales strategy in the U.S. while also playing a key role in the development of strategic offerings in response to market demand and clients' needs. Among his top priorities, Rob will be focused on expanding the healthcare sales team by year-end, while also further refining the efforts and approach of the existing sales organization.

Following the actions we've taken to date combined with Rob's leadership, I am confident that CTG will be increasingly better positioned to capitalize on the substantial market opportunities within the healthcare industry.

Our third focus area is Diversified Industrials. This business focuses on clients in oil and gas, food and beverage logistics, municipalities and engineering and construction. They have looked at CTG for strategic consulting solutions delivered by our unique team of highly skilled solution architects and software engineers. Significant budget pressures have been a constant headwind for our oil-related clients and for the state of Alaska, where a large portion of our diversified industrials business is concentrated. Despite these challenging budget dynamics, our team has continued to demonstrate progress on a number of meaningful engagements by offering technology solutions that help clients reduce cost.

As one example, we recently secured a Master Service Agreement with a notable municipality in Alaska for a diverse set of IT services. One of our key initiatives is to leverage the strategic consulting and technical capabilities demonstrated within this area of our business more broadly across the larger organization by proactively working to expand this proven platform.

In support of these efforts, we are actively partnering and participating in teaming agreements with complementary providers to pursue new opportunities for our high value solutions, such as 3D virtualization of facilities and business process management. As our pipeline of new business opportunities grows for these high value solutions, we expect to further expand the scope and targeted geographies for these offerings.

In conclusion, while we were disappointed by the impact of the recurring headwinds at our largest staffing clients and the unexpected increase that medical costs had on our financial results, I am very encouraged by what the team has accomplished. We're demonstrating tangible evidence of successful execution on our focused new business efforts in support of CTGs strategic growth initiatives.

Our pipeline continues to be one of the strongest that we have seen in the company's recent history. As a result, we are increasingly better positioned to drive consolidated growth through a series of more diversified revenue streams, and we remain resilient in our execution on a strategic plan implemented earlier this year. Although it will take time for the new business that we have secured to ramp up and collectively offset this weakness, we remain confident that our actions will result in future growth, increased profitability and ultimately the achievement of our long term targets.

With that, I'll turn the call over to John for a more detailed review of our financial results and guidance.

John Laubacker. Thank you, Bud. Good morning, everyone. We appreciate you joining us on today's conference call. As we indicated in this morning's news release, revenue in the third quarter was $74 million, compared with $75.5 million in the second quarter of 2017 and $78.1 million in the third quarter of 2016. Third quarter 2017 revenue included a $963,000 benefit from currency translation. We had 63 billing days in the third quarter, the same number as in the year ago quarter.

Staffing revenue in the third quarter was $52.1 million, representing a decline of 1.6% sequentially and 6.8% year-over-year, primarily due to reduced buying from our largest staffing accounts. Revenue from our solutions business in the third quarter declined 2.9% sequentially and 1% compared to the year ago quarter. Excluding our three largest clients, total revenue in the quarter increased 6.7% year-over-year.

Revenue from IBM in the third quarter was $18.6 million, or 25.1% of total revenue, compared with $19 million, or 25.1% in the second quarter of 2017, and $24.4 million, or 31.3% of total revenue in last year's third quarter. Revenue from Lenovo in the third quarter was $8.4 million, or 11.3% of total revenue, compared with $9.4 million, or 12.5% in the second quarter of 2017, and $8.6 million, or 11% of total revenue in the third quarter of 2016.

As Bud mentioned, during the quarter CTG incurred a significant and unexpected increase in medical costs associated with the Company's self-insured plan. These medical expenses were well above historical averages and primarily due to unusually high critical illness claims and higher overall utilization of our plan. On a per employee basis, medical costs in the third quarter were approximately 25% higher than in the second quarter of 2017 and more than 50% higher than in the third quarter of 2016. Based on the information available today, we do not believe these increased costs represent a new normal and anticipate a return to more historical averages in the coming quarters. I would also like to point out that CTG carries insurance that caps our exposure for any individual claim to $200,000.

GAAP net income in the third quarter of 2017 was $40,000, or $0.00 per diluted share, which included the higher medical costs that totaled $700,000 after-tax, or $0.05 per share. Non-GAAP net income, excluding this charge, was $0.05 per diluted share, compared with non-GAAP net income in the second quarter of 2017 of $1 million, or $0.06 per diluted share and non-GAAP net income of $600,000, or $0.04 per diluted share in the third quarter of 2016.

CTG's headcount at the end of the third quarter was approximately 3,250, compared with 3,350 at the end of the second quarter of 2017 and 3,550 at the end of the third quarter of 2016. Approximately 90% of our third quarter 2017 employees were billable resources, consistent with previous levels.

Turning to our balance sheet, cash and short-term investments at the end of the third quarter were $11.4 million and we had no outstanding long-term debt at quarter-end. The cash surrender value of life insurance policies on 20 former employees was $30.6 million at the end of the quarter. CTG is able to borrow up to $17.5 million against these policies under the terms of our revolving credit agreement.

We continue to have a goal of combining our Buffalo-based employees into a single building here in Buffalo. We estimate that consolidating into a single building could reduce our annual operating expenses by approximately $0.02 per share. As such, we continue to pursue a sale of our three story office building, which had a net book value of $1.6 million at quarter-end.

CTG's tangible book value at the end of the third quarter was $5.06 per share.

I also want to highlight that CTG's board recently increased the share repurchase authorization by $10 million, bringing the total authorization to $20 million. During the third quarter of 2017 the company repurchased 276,000 shares at an average price of $5.42 per share, for a total cost of approximately $1.5 million. As of yesterday, we had approximately $13.9 million available under the expanded repurchase authorization.

Turning to our guidance, we anticipate total revenue in the fourth quarter of 2017 to be in the range between $72 million and $75 million. Fourth quarter operating margin on a GAAP basis is expected to be between 1.8% and 2.2%. In addition, we expect fourth quarter GAAP net income to be in the range between $0.05 and $0.07 per diluted share. There are 63 billing days in both the fourth quarter of 2017 and 2016. The effective tax rate for the fourth quarter is expected to be approximately 36%.

We anticipate full year 2017 revenue to be in the range between $298.5 million and $301.5 million. GAAP operating margin for the year is expected to be approximately 1.3%. Full year GAAP net income is expected to be between $0.13 and $0.15 per share. Non-GAAP operating margin, which excludes the $0.05 per share charge for additional medical costs and a $0.03 per share charge for severance-related costs in the second quarter of 2017, is expected to be between 1.9% and 2.1%, while non-GAAP net income is expected to be between $0.21 and $0.23 per share.

Finally, we expect the effective tax rate for the full year of 2017 to be approximately 40%. Our revised fourth quarter and full year guidance reflects the ongoing soft demand at our larger staffing clients as well as the unexpected increase in medical costs realized during the third quarter. Despite these short-term challenges, we believe we are well-positioned to deliver revenue growth and increase profitability in 2018.

With that, we'll now open the call for questions. Operator, can you please manage our question-and-answer session. Thank you.

Operator. Thank you. The first question is from Mark Jordan of Noble Capital Markets.

Mark Jordan. Good morning, gentlemen. My question is wrapped around your final statement about being positioned for growth in 2018. Could you break that down as to what are your expectations are from your three largest customers? Do you see a chance of that moving towards a state of somewhat stabilization, or is this a function of the maturation of the business development process that allows you to get more significant growth outside of your largest customers?

Bud Crumlish. Actually, as far as the three largest clients go, we're hoping to see incremental business in the future, it's certainly difficult for us to tell, but we're optimistic about that. And so we're really focused on having our sales teams drive business more at the mid-market level, that's where we're adding to our sales teams to go after those markets, as well as gain higher margin with pursuing those opportunities.

Mark Jordan. A question that's more longer term. As you start growing again, what is your longer-term business model? And by that I mean, what do you think is a reasonable operating margin goal for this company, and what would it take to achieve that?

John Laubacker. Mark, really two thoughts. Our long-term plan that we put out earlier this year has got us approaching $400 million in revenue by the end of 2019, and a margin of 3% to 3.5%, so say 3.2%, 3.3%, and that really continues to be our long-term goal to try and reach that.

As Bud just indicated, our sales business development efforts are really focused on the middle market. So, part of achieving that revenue growth and part of achieving that increased margin from where we are today is growing that business outside of our largest clients, to expand that business, to have opportunities where the margin is a little bit better than having the large volume relationships that we have.

Operator. Our next question is from Vincent Colicchio of Barrington Research.

Vince Colicchio. Just to be sure, the new business you've closed, is that largely showing the success of the midsize market focus?

Bud Crumlish. Actually, it's a combination of both; it's not just the midsize, there is certainly some of that, and we've signed contracts, and as you can imagine it takes time to ramp those up, but it's really a combination of some larger clients as well as midsize as well.

Vince Colicchio. Bud, you had mentioned the IT services contract, the size you thought it could be. I missed that. Could you repeat that?

Bud Crumlish. Yes. Historically, we've had revenue from our IT services contract in excess of $70 million annually.

Vince Colicchio. And the margin on that we should expect to be higher than average, or how does that look?

Bud Crumlish. Well, that's with the staffing business in general, especially doing that kind of volume, as you can imagine there is the volume buying power that clients have, so typically that's more on the lower end.

Vince Colicchio. On the healthcare side, you're talking about expanding the sales force. I just need to ask, what gives you confidence that that will bear fruit at this point? I know the previous leadership had tried to do that and it didn't really bear fruit. Any comments on that would be helpful.

Bud Crumlish. I think on the sales force there are certain areas that we're going after specifically, and with Rob Barras joining the organization I think that's a big plus. He's got a lot of relationships at a lot of different healthcare institutions, not only the hospitals but the payers. I think it's a matter of having the people focused, trained and what we have to offer and take from the market.

It's a different environment. Five or six years ago it was more of a coordination of a sales type of engagement, meaning that it wasn't as difficult to really get it (business), it was a more of a challenge to actually get the technical resources to put on the assignment, and now we have to hunt and we have to put more effort into it to close business. And I really think that with our focused efforts—we're not going to be everything to all people—we're going to go after specific focused offerings, and with the leadership of Rob, I think that's going to make a difference.

Vince Colicchio. Is there anything we're looking out on the acquisition side as far as tuck-ins, or is that a back burner?

John Laubacker. We're regularly looking at those opportunities, and if we find something that makes sense, both from a size perspective and from a talent perspective—something that we can add into the organization that will expand our skill set, maybe bring us into an area that we aren't today in as far as skills—we would definitely consider moving forward.

Operator. Our next question is from Kevin Liu of B. Riley & Company.

Kevin Liu. You talked about a couple of your new wins on the staffing side that have the potential to take those to some top-five customers of your company; what sort of level of revenues does that entail? And could you just repeat whether all this could occur within 2018, or if this is more longer term before they get to those levels?

Bud Crumlish. Well, certainly some of the new wins, I would say a good portion of that would be in 2018. We're just initiating them now, so it's going to certainly take time. But I would see a continued ramp up in 2018, and then it could increase even further in 2019. But we're just starting out now and it's going to certainly take some time to do that, but we definitely see things that are going to happen relatively quickly and then continue on to ramp.

John Laubacker. To be a top five or so client you'd be north of $10 million in annual revenue.

Kevin Liu. That's helpful. And then, it sounds like you're still fairly confident in achieving the goals that you have by the end of 2019, but maybe given what you've seen with your largest customers, is there any big risk that you see towards getting to those numbers? And in terms of mix, would you envision a substantial shift toward the solutions side in order to help drive some of the margin goals?

Bud Crumlish. Well, I'll talk about the solutions first. We're absolutely growing our solutions business, and that will help not only our top line, but certainly our bottom line; it will have more of a dramatic effect.

In terms of our business with those accounts, I'm optimistic. I'm confident that we will be able to really hit our targets, the ones that we put out early this year in our letter to our shareholders. There are a number of things we have in place. As I mentioned earlier, we have the largest pipeline of opportunity that we've seen in a long, long time, and we're executing on those, we're adding our sales people, we're being diligent and holding people accountable and moving forward. So I still feel confident that we will achieve those targets that we put out there.

Kevin Liu. Just one housekeeping item. I think you talked about the after-tax impact of the medical expenses. What was the pretax number and how does that split out between your cost of revenue and SG&A?

John Laubacker. In total it was $1.2 million additional that we booked pretax during the quarter, of which $1 million went into direct costs and $200,000 went into SG&A.

Operator. We have no further questions in queue at this time.

Bud Crumlish. Thank you, Kevin. Before closing the call, I would like to emphasize my continued confidence in CTG's ability to execute against our strategic goals. We are intently focused on those items that we can control, including converting our growing pipeline from prospects into contracted new business in combination with the expansion of our global sales organization.

I should point out that the vast majority of the most meaningful deals we have closed in the last 90 days are only in the early stages of ramping, which further positions CTG for future growth. Most importantly, the team's focused execution continues to demonstrate tangible evidence of success, as we saw in the third quarter. Additionally, we continue to take steps to align with our interests with those of our shareholders as well as return capital through our stock buyback program.

With that, I will conclude today's call and want to thank you for joining us today. We look forward to providing an update on our continued progress on our fourth quarter and full year 2017 call early next year.